Market Review

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Rebalance IRA's Chief Investment Officer, Mitch Tuchman, along with Sally Brandon, Vice President of Client Services, present the Winter 2017 *Market Review Conference Call*. Listen In!

Winter 2017

Fake News: Wall Street's Sleight of Hand

In all meaningful life pursuits, we want an answer to the important question, *"How am I doing?"* As a kid playing sports or challenging oneself to better grades, as an adult working to get ahead in a career, or as a parent who cares about the progress his or her children make, we all measure and compare ourselves against some standard. And then we reach a conclusion that leads us to feel satisfied, elated, excited, or relieved, and often, jealous, afraid, upset, or disappointed.

Even as a society, everything is tracked with great numerical precision so that we know *"how we are doing."* There are economic indicators, the Dow Jones average, weather patterns, field goals achieved, batting averages, SAT scores, college admission rates, and credit scores.

But of all these life pursuits, few generate as much emotion as the subject of money. Consider these questions below and take note of how you feel about each:

- How much do (or did) you make compared to your best friend?
- What is your "net worth," and is it enough?
- Who has more than you, and what did they do that you didn't?
- Who has less than you, and do you judge them for it?
- What can you not afford to buy for your family and why not?

Those who sell financial services know how emotionally charged these questions can be. They know when we are most vulnerable; when we are losing money, when we are "missing out" on making money, or when we worry that one day we won't have enough money. And unfortunately, many of these "salesmen" adeptly turn our emotions against us.

During the recent U.S. presidential election, "fake news" became the topic of the day. Cambridge University social psychologist Sander van der Linden says that we fall for fake news because our brains use shortcuts to process large amounts of information that is hard to understand. As a result, we are quick to believe information presented to us as a consensus, or from what appears to be a highly credible source.

No one is better at using fake news than financial services marketers. Investment jargon is hard to understand and process for most of us, so naturally we are vulnerable to it. Our brains want shortcuts.

In a recent study, van der Linden "inoculated" subjects against the fake news surrounding anti-climate change rhetoric by giving them a "vaccine." In effect, he made it clear when information was politically motivated. And when a warning explained why the information was inaccurate — for example, a climate-change petition supposedly signed by 30,000 scientists that included the signatures of Charles Darwin and the Spice Girls — the vaccine effect was even greater.

Investor vaccine

Like Professor van der Linden, we wish to inoculate our clients and friends from the most powerful form of fake news for investors - investment return calculations - easily the most manipulated and over-simplified measurement of "how things are going."

Here are three items to consider with any investment return calculation, each of them a powerful vaccine against being misled:

1. Consider the source. Mutual fund companies (such as American Funds, T. Rowe Price, Janus, and Franklin Templeton) advertise investment returns solely to convince that you will do better with their funds. But funds have multiple ways to emphasize and literally to manipulate those returns. For instance, often companies merge a poorly performing fund into a great-performing one to erase the poorly performing fund's results. This makes their 20-year track records look amazing when they are not.

It is like going to a college for three years, achieving a 2.3 GPA and then transferring to a new college. At the new school you achieve a 3.5 GPA in your senior year and now, like magic, report an overall 3.5 college GPA! This is just one tactic used to mislead investors. Ask yourself, who gains by showing you this data, and how could they be tilting it to their favor?

2. How much could you have lost? Here is a trick question: On Jan. 1 you buy $1,000 of Apple stock and we buy $1,000 of a fund that holds the S&P 500 (an index of 500 large U.S. stocks, including Apple, Disney, Exxon, Citibank and many others). By Dec. 31, we both have $1,100. Did we have the same performance?

The answer is "no." You took more risk by owning one stock than we did by owning 500 stocks to get the same return. Sure, we all think that Apple is "safe." But many thought Enron was safe, too. Last year, the smartest hedge fund managers in the world thought Valeant Pharmaceutics was "safe." Far from it! Any one company's stock can tumble – sometimes forever.

It is impossible to measure what you made without considering what you could have lost. Therefore, presenting investment returns without adjusting for risk taken tells only half of the story.

Concentrating your money in a single stock, a single sector grouping (such as tech, energy or healthcare), or even in the stocks of one country is much riskier because companies go broke, and sectors and whole countries can have declines that last for more than a decade. For instance, it took the NASDAQ 16 years to return to its previous peak from the "dot-com" bubble.

Investment risk simply means: *"What are the odds of permanently losing some or all of my money?"* Professionals adjust returns for the risk taken. A 25% return from an investor that could have lost

Enron Stock Prices

August 23, 2000 to January 11, 2001

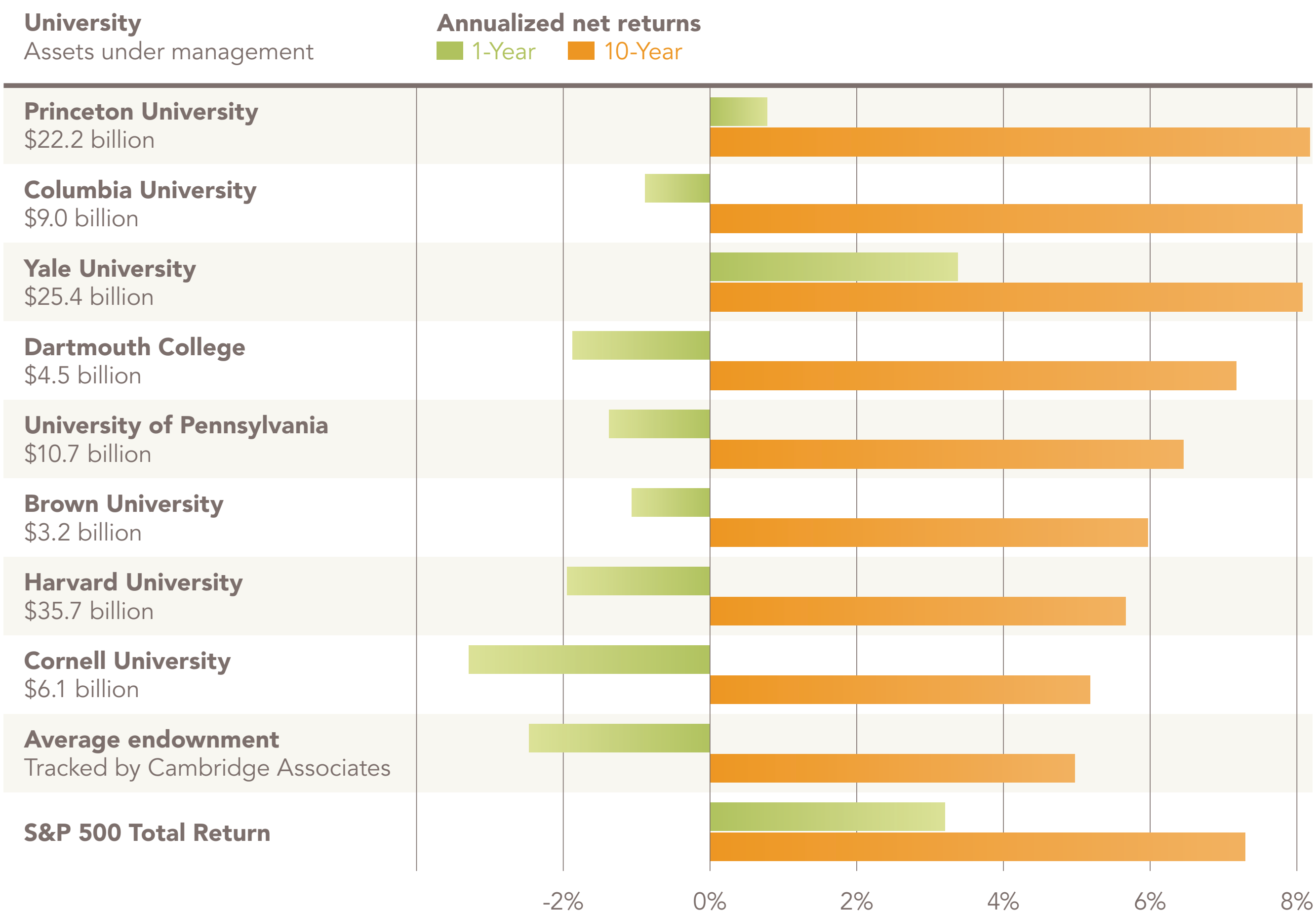
everything is not as good as a 10% return where one's money was completely safe from loss.

3. Compared to what? The media and fund companies lead us to believe that we should compare our personal rate of return to the S&P 500 or "the Dow" to answer the question *"How am I doing?"* For retirement portfolios, such comparisons are apples-to-oranges and highly misleading.

Professional investors build retirement portfolios to be safer than just the Dow or the S&P 500 by including many other types of investments. **Rebalance IRA** portfolios, for instance, include various types of bonds, real estate, and international and small company stocks, precisely in order to lower risk.

To answer the "How am I doing" question, a portfolio must be compared against a benchmark portfolio with the same level of risk. There is an entire industry around helping professional managers do this properly.

At **Rebalance IRA**, we show clients how their portfolios behave relative to the risk taken. One benchmark we watch is the returns reported by the most sophisticated U.S. university endowments - world's best investors. The average endowment achieved about a 5% return over the last 10 years, including the 2008 Great Recession (which depressed all returns) without much risk. The best five endowments achieved returns of between 6% and 8%.



Note: Data as of June 30, 2016. Sources: the universities; FactStep (S&P)

Stay Immune

When it comes to investing, everyone wants a satisfying answer to the *"How am I doing"* question. But, because we want so badly to be satisfied, we are easily misled. Use the three strategies described above when looking at your returns and you will be immune to the kind of financial fake news that can be so damaging to your retirement security.

The **Rebalance IRA** Investment Committee works with two broad asset classes for the basic building blocks of our client's retirement portfolios: Growth and Income. During the fourth quarter of 2016, these asset classes performed as follows:

Growth Asset Classes*	Q1 2016 Returns	Q2 2016 Returns	Q3 2016 Returns	Q4 2016 Returns	2016 Returns
U.S. Total Market (VTI)	1.0%	2.7%	4.4%	4.2%	**12.9%**
U.S. Small Cap (IJR)	2.6%	3.8%	7.1%	11.2%	**26.6%**
Emerging Markets (VWO)	5.9%	2.6%	8.2%	-4.5%	**12.3%**
Foreign Developed (VEA)	-1.9%	0.0%	6.3%	-1.5%	**2.7%**
International Small Cap (VSS)	0.6%	0.6%	7.5%	-4.0%	**4.3%**
U.S. Real Estate (VNQ)	6.3%	6.8%	-1.5%	2.8%	**8.7%**

Income Asset Classes*	Q1 2016 Returns	Q2 2016 Returns	Q3 2016 Returns	Q4 2016 Returns	2016 Returns
High-Yield Dividend Equities (VYM)	4.2%	4.4%	1.7%	6.0%	**17.1%**
US Corporate Bonds (VCIT)	3.9%	3.7%	1.0%	-3.3%	**5.3%**
High-Yield Corporate Bonds (HYG)	2.4%	5.2%	4.4%	0.9%	**13.4%**
Emerging Market Bonds (EMB)	5.2%	5.6%	3.1%	-4.6%	**9.3%**

*Returns displayed representing the major asset classes of **Rebalance IRA** portfolios include dividends as measured using the ETFs shown in parenthesis.

Growth Asset Classes

U.S. Stocks. Neither the surprise presidential election outcome nor a long-awaited increase in U.S. interest rates seemed to be enough to dampen investor demand for U.S. stocks. The asset class notched another solid quarter to finish the year in double-digit territory. It is impossible to say where stocks will be in a few months (or even a few days), but as of the end of January 2017, President Trump seems to be enjoying at least some of the “wait and see” period most presidents receive from investors.

Small Cap Stocks. Small U.S. companies roared in the final three months of year, stacking 11.2% on top of solid gains all year and leading all of **Rebalance IRA** asset classes for the full year. Of course, the great run in 2016 followed a weaker performance 2015. It is important to remember that we own small caps for their long-term average gains, despite their natural volatility, because diversification is the key to investment performance over time.

Emerging Market Stocks. After a solid three quarters, emerging country stocks took a hit on the election of Donald Trump. Partly that was out of concern for the economy of Mexico should Trump attempt to renegotiate NAFTA. While Mexico is a small part of this asset class, most of the drop was concern over trade barriers with China, and a stronger dollar driven by the potential of increased U.S. spending on infrastructure. Neither of these events is happening quickly, so it is hard to say what direction emerging stocks will head next. Of course, as prices of assets fall, our firm’s rebalancing policies lead us to add to these positions.

Real Estate Stocks. Rebalance IRA owns real estate stocks in our clients’ portfolios as a means of diversifying away from pure capital appreciation and in order to reduce volatility. After a solid first half, the property market slowed in the second half in anticipation of rising borrowing costs. Nevertheless, home prices remain solidly high and building has not kept pace in the parts of the country where demand is high. If job growth remains steady, so too will housing demand. That could buoy real estate.

Large European, Japanese & Asian Stocks. European stocks gained in the fourth quarter in their own currencies, but U.S. investors saw those increases lost to currency changes as the euro sharply declined against the dollar. The currency shift was the result of contrary monetary policies as the European Central Bank enacted a stimulus while the U.S. Federal Reserve raised rates. A similar trend played out in Japan, as stocks there rose in value but the falling yen erased gains in dollar terms.

Income Asset Classes

U.S. Corporate Bonds. Bond prices slipped in the fourth quarter, the natural result of the long-anticipated Fed decision to raise the interest rate in December for only the second time in nearly a decade. For the year, however, bonds notched a reasonably solid return. It seems unlikely that the monetary authority will rush to judgement on the U.S. economy until the new administration is fully underway. **Rebalance IRA** clients are, naturally, broadly diversified in the total bond market, an approach which limits the potential negative effects of unexpected policy moves.

High Yield Corporate Bonds. The junk bond market settled down in the final quarter of the year after a solid first three periods. If the new administration allows large corporations a "tax amnesty" for bringing back the trillions of dollars being held overseas, this would increase M&A activity and more high-yield financing to go along with it. Nobody really knows what will come next, of course. Rather, our clients own this asset class precisely because the yield is highly attractive and its volatility lowers overall portfolio risk.

Emerging Market Bonds. A pop in the U.S. interest rate pushed emerging market debt lower in the final quarter of the year. Still, the asset class returned a solid 9.3% in 2016, well above historical domestic bond returns. A stronger dollar could keep demand for foreign debt on its back legs, but falling bond prices naturally will increase investor interest in the asset class, supporting demand.

High Yield Dividend Equities. A slower-moving Fed, however, suggests that demand for income outside of the bond market will maintain interest in dividend stocks for a while longer. As long as the jury remains out on faster economic growth at home, expect investor demand to remain steady in this asset class — at least until interest rates begin to climb in a permanent way.

The Rebalance IRA Investment Process

Rebalance IRA portfolios are diversified into thousands of stocks and bonds in the United States and more than 45 foreign countries. Market cycles will continue. Research going back decades, much of it done by members of the **Rebalance IRA** Investment Committee, shows that using those cycles in a prudent manner is the most effective long-term strategy for retirement investing.

By systematically rebalancing our clients' portfolios, we are able to take advantage of market gyrations. Trimming what has gotten rich, and adding to what has soured, enables us to take advantage of market ups and downs, rather than becoming paralyzed by it. **Rebalance IRA** proprietary portfolios rely on multiple ways to deliver returns to our clients that are commensurate with the risk taken.

The **Rebalance IRA** Investment Committee has created a vigilant and disciplined rebalancing process that assures that our client portfolios are managed using the best practices of sophisticated endowments and pension funds. We will alert you when we are about to trim winning asset classes, and buy more of the losing asset classes, so that you can better understand how we are managing your money.

Your portfolio is premised on the dialogue that we have with you to understand your situation, risk tolerance and liquidity needs. Our goal: to help you reach your retirement investing goals with the lowest assumed risk possible.

We value your trust and look forward to many years of prudent and profitable investing. And, if at any time you would like to talk, please feel free to send us an email or give us a phone call.

Very truly yours,

Your **Rebalance IRA** Team

The Rebalance IRA Investment Committee

Burton Malkiel, Charles Ellis and Jay Vivian comprise the **Rebalance IRA** Investment Committee. They are renowned for creating and implementing sophisticated investment methods used today by elite pensions and endowments. The Investment Committee actively develops, oversees and sets policies for the portfolios offered to **Rebalance IRA** clients. Their core ideas include diversification across multiple types of assets on a global basis and disciplined portfolio rebalancing. They also advocate techniques for keeping investment fees low.

Professor Malkiel is an emeritus Princeton University economics professor, a former board member of The Vanguard Group, and the author of the investment classic *A Random Walk Down Wall Street*.

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading investment advisor to large pools of institutional capital around the world. He was Chairman of the Investment Committee of the famed Yale Endowment, and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide.